

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 218

June 30, 1958

DEPLETION: ROYALTY BASED ON CYCLING PLANT OPERATIONS: LESSOR'S SHARE OF TAXES PAID BY LESSEE

Syllabus:

The lessor's "gross income from the property" for purposes of computing depletion, where royalties are based on the net proceeds from the sale of products produced in a cycling plant operation, is the amount received from the lessee; such gross income also includes the lessor's share of property taxes paid by the lessee pursuant to the lease.

Taxpayer is the owner-lessor of oil and gas producing land. The lessees operate the properties and, in addition, operate a cycling plant in which the gas produced by the wells is processed. The leases provide that the lessor shall be paid a royalty in cash of 1/6 and 10 percent, respectively, of the net proceeds from the products sold by the lessees. The lessees pay all of the property taxes on the properties including the lessor's share, pursuant to the leases. In their returns, taxpayers treated the case received from the lessees as the amount of gross income from the properties upon which to compute the percentage depletion deduction.

Advice is requested as to what amount is the lessor's "gross income from the properties" for the purpose of computing the allowance for depletion in accordance with Section 17686 of the Personal Income Tax Law.

The practice of the Internal Revenue Service appears to be to treat the full amount of the royalty paid to the landowner as gross income of the lessee. Inasmuch as the landowner's economic interest is only in the extraction of oil and gas from the property it is reasonable to consider that the amounts received by him are royalties from the production of oil and gas rather than being, in part, from a manufacturing process; in other words sharing in the net proceeds is only a method of computing royalty; not an additional share in the manufacturing operation.

The statute provides that the taxpayer must exclude from depletable gross income from the property any rents or royalties paid or incurred by the taxpayer in respect of the property. Therefore, the lessee must exclude from its share of the gross income from production the full amount of royalty paid to the lessor. Thus the depletion allowances taken by both the lessor and the lessee together

are computed on only the total gross income from the property that is subject to the depletion allowance.

The Internal Revenue Service has ruled that where the lessee pays the lessor's share of ad valorem property taxes pursuant to the terms of the lease, the amount constitutes additional royalty income to the lessor to the extent that there is sufficient income from the lease to cover the amount. Rev. Rul. 16, 1953-1 Cum. Bull. 173. Accordingly, it must be excluded by the lessee from the depletable gross income from the property. Rev. Rul 54-600, 1954-2 Cum. Bull. 164.